

# Insolvency Notes

June 2009

## Chapter 11 Ruling Calls into Question Basic Tenets of Securitization Structures



On May 14, 2009, Judge Allan Gropper of the US Bankruptcy Court, Southern District of New York, approved a US\$400 million DIP financing package in the US\$27 billion General Growth Properties, Inc. (“**GGP**”) Chapter 11 case. Judge Gropper’s ruling also included approval of GGP’s proposal to use cash flow generated by shopping centers, structured by GGP as bankruptcy remote, special purpose entities, to fund GGP’s ongoing central operations while in bankruptcy.

The bankruptcy filing by the GGP subsidiaries and Judge Gropper’s ruling appear to call into question two basic tenets of securitization structures: (1) that the entity holding the securitized assets will remain out of the reach of the equitable powers of a bankruptcy court and (2) that a special purpose entity’s assets will not be used to support the bankruptcy estate of the parent sponsor.

While Judge Gropper’s ruling may or may not have a significant economic effect on the lenders of the GGP subsidiaries (only time will tell), the true significance of the GGP proceeding in the near term is the uncertainty it likely will introduce with respect to the status of wholly owned special purpose entities that were structured to be bankruptcy remote and the impact this may have on the ratings assigned to asset-backed securities issued in transactions involving such entities.

The GGP case is significant to the securitization and structured finance markets. A premise of those markets is that the assets used as the credit source for an asset-backed security’s repayment are largely isolated from the equitable powers of a bankruptcy court. By remaining outside the forces of equity, the parties to the transaction can have certainty that the contractual provisions of the transaction’s documents will always govern the application of the cash proceeds of a securitized asset. By structuring a transaction to remove the uncertainty created by a bankruptcy filing, both the rating agencies assigning a rating to the transaction and the lender or noteholder providing financing can base their assessment on the quality and payment history of the securitized asset rather than on the financial situation of the entity sponsoring the securitization transaction.

A securitization transaction generally will carry a higher rating than the corporate rating assigned to the parent company sponsor; otherwise, there is little incentive to structure a securitization transaction. By (i) removing the risk of a bankruptcy court using its equitable powers, including but not limited to the automatic stay, to delay and/or vary the application of the proceeds of the securitized asset from the explicit requirements of the transaction documents and, where applicable, (ii) obtaining a higher credit rating for the asset-backed security, the borrower/asset-backed security issuer is able to obtain a lower interest rate

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in a securitized transaction compared to the rate that a lender would otherwise make in a loan to the ultimate corporate owner of the asset.

We will continue to monitor developments in the GGP case and their effect on the capital markets.

### Background

GGP, through various subsidiaries (the “**Property Owners**”), owns and operates more than 200 shopping centers in 44 jurisdictions throughout the US, and is one of the largest borrowers in the commercial mortgage-backed securities (“**CMBS**”) market.

On April 16, 2009, GGP and its operating partnership subsidiary, GGP Limited Partnership (“**GGP LP**”), surprised creditors when they filed for Chapter 11 bankruptcy protection after amassing aggregate debt in excess of US\$27 billion (one of the largest real estate bankruptcies in US history).

GGP blamed the global credit crisis for its collapse, citing that no debt sources were available to refinance its maturing mortgage and corporate loans. According to its filing, GGP’s debt-to-asset ratio was 92 percent at the time it initially sought bankruptcy protection.

### Bankruptcy Filing by the Bankruptcy Remote Entities

In addition to the Chapter 11 filings made by GGP and GGP LP, GGP also caused more than one hundred of the Property Owners (owning 166 securitized shopping center properties) to individually file for Chapter 11 bankruptcy protection.

Many of the Property Owners included in the Chapter 11 filing were formed as bankruptcy-remote, special purpose entities (the “**Subsidiary SPEs**”) for the purpose of issuing debt eligible to be included in pools of loans backing rated CMBS. The filing of the Subsidiary SPEs was controversial because (i) most of the Subsidiary SPEs were solvent and cash-flow positive, (ii) many required unanimous consent of the directors (including one or more independent directors) to file an insolvency proceeding and (iii) GGP purportedly recently replaced the independent directors and successfully achieved the unanimous consent required for the filing.

## Use of Cash Collateral and DIP Financing

### GGP Request and Argument

The Subsidiary SPEs are parties to various CMBS financing arrangements with property-level secured mortgage lenders (the “**SPE Lenders**”). In light of the bankruptcy filings, cash generated from the operations of the Subsidiary SPEs party to such loans is “cash collateral” subject to the restrictions on use imposed by the Bankruptcy Code. GGP filed a motion (the “**Motion**”) seeking authority to use SPE Lenders’ cash collateral to fund GGP’s central operations and maintain its businesses as going concerns. In exchange for use of the SPE Lenders’ cash collateral, the debtors proposed providing the SPE Lenders with “adequate protection” by, among other things, (1) granting the SPE Lenders liens on the intercompany claims (with, as initially proposed, such liens being junior to any liens granted in favor of the third party debtor-in-possession financing lenders discussed below), (2) paying postpetition interest to the SPE Lenders at the non-default contract rate set forth in the respective loan documents and (3) continuing to maintain the securitized shopping center properties. The SPE Lenders did not consent to such use of the cash collateral by GGP and many of the SPE Lenders believed such use would be to their detriment.

The Motion also sought authorization and approval for the debtors to borrow US\$375 million pursuant to a debtor-in-possession (“**DIP**”) loan from PS Green Holdings, LLC, an affiliate of Pershing Square Capital Management, LP. Pursuant to the terms of the proposed debtor-in-possession loan, the lender was to be granted a first lien on all the assets of the debtors subject only to existing liens, including the liens in favor of the SPE Lenders. GGP further proposed that the Property Owners guarantee the DIP financing and secure those guarantees with liens on substantially all their assets, subject only to existing liens.

GGP also filed a motion seeking permission to continue its prepetition cash management practices. The GGP proposal included an affiliate DIP loan concept, through which intercompany loans would be made by Property Owners and, in return, each of the Property Owners making an intercompany loan would be given an administrative claim in the bankruptcy case of the entity receiving the cash. The GGP proposal, including continuing its cash management system, would effectively turn the Property Owners into DIP lenders to GGP secured by administrative bankruptcy claims.

## Objections

The GGP proposals were subject to numerous objections from the SPE Lenders, other secured and unsecured creditors, as well as from trade groups representing the commercial real-estate industry, such as the Commercial Mortgage Securities Association (“**CMSA**”) and the Mortgage Bankers Association (“**MBA**”). CMSA and MBA filed an amicus brief with the US Bankruptcy Court, Southern District of New York, on May 1, 2009, to mark the record and state their concerns.

The objections from the SPE Lenders centered on, among other arguments, the following: (i) many of GGP’s shopping centers remained profitable and should not be in bankruptcy at all, (ii) GGP’s use of a main operating account that centralized all cash flows was a form of substantive consolidation and (iii) GGP should not have access to the cash flow generated by such properties. The SPE Lenders further argued that “adequate protection” of their collateral had not been provided and that other separateness covenants, such as those relating to “independent” directors, had been breached by the Subsidiary SPEs.

CMSA and MBA also argued that allowing GGP to include the Subsidiary SPEs in its bankruptcy case would set a toxic precedent for the entire CMBS market by calling into question the comfort given to the lending markets by having the assets of a special purpose entity borrower isolated and protected from creditors of other affiliated entities.

In addition, CMSA and MBA were concerned with the bankruptcy filings by the individual Subsidiary SPEs as part of the GGP Chapter 11 filing and the impact such precedent could have on the CMBS market, the fundamental principles of structured finance and the broader capital markets that rely on the same underlying principles.

CMSA and MBA also noted that while GGP’s most recent annual report describes most of its mortgage debt as “non-recourse notes collateralized by individual properties,” GGP’s bankruptcy filing sought to recharacterize each of its Subsidiary SPEs as one enterprise with all assets held for the benefit of the collective whole. Finally, CMSA and MBA argued that if a lender cannot rely on the basic corporate formality of entity separateness and express separateness covenants, the foundation on which nonrecourse asset specific financing is built would be destroyed.

## Ruling of the Court

By order dated May 14, 2009, Judge Allan Gropper of the US Bankruptcy Court, Southern District of New York, approved a US\$400 million DIP financing package (the “**DIP Financing**”) submitted by an alternative consortium of lenders led by Farallon Capital Management LLC (the “**DIP Lenders**”). Judge Gropper’s ruling also included the approval of GGP’s proposal to use cash collateral generated by many of the shopping centers owned by GGP through the Property Owners to fund GGP’s operations, despite the objections of the SPE Lenders that such use should not be permitted and adequate protection was otherwise lacking. Under the terms of such use of cash collateral, however, as modified by the debtors prior to the hearing the SPE Lenders will have, as partial adequate protection, first priority liens on the central GGP cash operating account and the intercompany claims and the Subsidiary SPEs will be required to continue to pay mortgage interest to the SPE Lenders at the prefiling rate.

With respect to the DIP Financing, Judge Gropper also ruled that (i) each applicable Property Owner will grant junior liens to the DIP Lenders on the assets securing the obligations to the SPE Lenders, as well as senior liens on other unencumbered assets, and (ii) the DIP Lenders will also be granted junior liens on a group of other GGP affiliate-owned properties.

Judge Gropper, in his May 13 ruling from the bench, specifically attacked the CMSA and MBA amicus brief. Judge Gropper stated, “I take serious exception to some of the arguments...of systemic risk from a case like this. Obviously, a case like this raises difficult issues because there are so many debtors.”

Judge Gropper overruled many of the objections of the SPE Lenders, stating that the SPE Lenders’ rights in respect of the cash collateral were adequately protected, and GGP should have access to cash collected at the Property Owner level. Judge Gropper added that these lenders “assert their rights to this cash collateral are inviolate. That of course is not the law.”

Judge Gropper further stated that GGP had adequately protected the cash collateral of holders of CMBS and other loans backed by GGP’s shopping centers by continuing to pay interest on those loans and by providing those creditors with administrative claims to cash flow from the properties securing their loans diverted for corporate use in any liquidation scenario.

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